IT 02-3
Tax Type: Income Tax
Issue: Enterprise Zone (Exemptions)
Books And Records Insufficient

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS,	No. 01-IT-0000 FEIN 00-0000000
v.	Tax Years 1995, 1996, 1997
"MARCHBROD CORPORATION" **Taxpayer**	**Ted Sherrod** **Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Assistant Attorneys General Rick Walton and Jessica Arong on behalf of the Illinois Department of Revenue; Robert E. Branson of Ward, Murray, Pace & Johnson, P.C., on behalf of "Marchibrod Corporation"

Synopsis:

This matter is before this administrative tribunal as the result of a timely protest by "Marchibrod Corporation" (hereinafter also referred to as “taxpayer”) of the Illinois Department of Revenue’s denial of the taxpayer’s claims for refund for the tax years ending December 31, 1995, December 31, 1996 and December 31, 1997. A pre-trial order was entered on July 11, 2001 in which the parties state the issues to be decided as: 1) whether the taxpayer is required to provide documentation regarding the use of its clients’ trucks in an enterprise zone in order to take a deduction for interest earned on loans to its clients to acquire vehicles used in the enterprise zone, 2) whether

documentation provided by the taxpayer was sufficient and 3) whether the Department properly concluded that the taxpayer failed to provide sufficient documentation as a result of its failure to produce its clients' logs verifying the percentage of time such vehicles were used within the enterprise zone during the tax period in controversy. A hearing was held at the Department's offices in Chicago, Illinois at which "John Doe", the taxpayer's accountant appeared and testified. Following a review of the record in this case, it is recommended that this matter be resolved in favor of the Department.

Findings of Fact:

1. The *prima facie* case of the Department, inclusive of all jurisdictional elements, was established by the admission into evidence of the Department's Exhibit 1. Tr. p. 6.

2. The Department issued a Notice of Denial to "Marchbrod Corporation", denying the taxpayer's claim for refund for the tax years 1995 through 1997. Dept. Ex. 1.[1]

3. Taxpayer (also known as "First National Bank of Marchibrod") is engaged in the conduct of a lending business in Illinois; the taxpayer's lending business includes making loans to acquire property located in enterprise zones, including loans to acquire trucks used in enterprise zones. Tr. pp. 9, 12, 13, 14, 15, 16, 30, 31, 32.

4. The taxpayer filed Illinois income tax returns for 1996 and 1997 on which it subtracted interest income on loans to acquire property located in an enterprise zone, including loans for trucks used in an enterprise zone by two trucking companies. Tr. pp. 12, 13, 14, 24, 25.

5. The Department performed an audit of the taxpayer covering the tax years 1996 and 1997; the audit included a review of the taxpayer's loan files to determine what loans qualified for enterprise zone related tax deductions. Tr. pp. 15, 16.

6. The auditor determined that interest on loans to acquire trucks used in an enterprise zone by two trucking companies did not qualify for the deduction allowed by 35 **ILCS** 5/203(b)(2)(M); the auditor's denial of this deduction for the tax years 1996 and 1997 reduced the taxpayer's loss carryback and thus increased the taxpayer's tax liability for 1995. Tr. pp. 12, 15, 16.

7. "John Doe" is a partner in the firm of "Winken, Blinken & Nod" ("Winken"); Mr. "Doe" is a certified public accountant and is the managing partner of "Winken's" (Someplace), Illinois office; he has been the taxpayer's accountant for 19 years. Tr. pp. 8, 9.

8. Mr. "Doe" prepared the taxpayer's tax returns for 1996 and 1997; Mr. "Doe" used a list of enterprise zone loans provided by the taxpayer as his basis for subtracting interest from loans to acquire property used in an enterprise zone on the taxpayer's Illinois income tax returns for these years. Tr. pp. 9, 12, 13, 14, 15, 24, 25.

9. During the audit, Mr. "Doe" obtained letters from the two trucking companies to which loans generating interest deducted by the taxpayer were made as support for these deductions; the Department's auditor determined that these letters were not sufficient documentation to support the taxpayer's claims. Tr. pp. 13, 15, 16.

10. Mr. "Doe" verified the existence of the enterprise zone in which trucks purchased with loans from the taxpayer were used, but did not attempt to independently verify the information reported in the letters supporting the taxpayer's deductions provided by the taxpayer's clients. Tr. pp. 22, 25, 26.

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[1] Unless otherwise noted, findings of fact apply to the tax years 1995, 1996 and 1997.

11. The taxpayer has no records indicating whether trucks purchased with loans from the taxpayer qualified for Enterprise Zone Investment Tax Credits under 35 **ILCS** 5/201(f). Tr. p. 28.

Conclusions of Law:

Section 203(b)(2)(M) of the Illinois Income Tax Act ("IITA"), 35 **ILCS** 5/203(b)(2)(M), provides that a financial organization[2] may take a deduction for interest income from a loan secured by property that is eligible for the Enterprise Zone Investment Credit. The Enterprise Zone Investment Credit is prescribed by section 201(f) of the IITA, 35 **ILCS** 5/201(f) (hereinafter "section 201(f)"). Section 201(f) provides that a taxpayer shall be allowed a credit against its Illinois income tax for investments in qualified property that is placed in service in an enterprise zone established pursuant to the Illinois Enterprise Zone Act, 20 **ILCS** 655/1 *et seq*. Section 201(f) and the Department's rules (see 86 Ill. Admin. Code 100.2110) provide an explanation of what constitutes property that qualifies for this credit (hereinafter "qualified property").

Trucks and other vehicles can constitute qualified property eligible for the Enterprise Zone Investment Credit. 86 Ill. Admin. Code sec. 100.2110(e)(4)(B). Moreover, the removal of such property from the enterprise zone for a temporary or transitory purpose does not disqualify the property. *Id*. However in order to qualify, such mobile property "must be used predominantly in an Illinois Enterprise Zone." *Id*. Vehicles and other mobile property are considered to be "used predominantly in an

[2] The term "financial organization" as used in the Illinois Income Tax Act is defined to include "any bank" or "bank holding company". 35 **ILCS** 5/1501(a)(8)(A). Consequently, the taxpayer, also known as "First National Bank of Marchibrod" (Tr. p. 9), was a "financial organization" for Illinois income tax purposes.

Illinois Enterprise Zone" if "usage in the Enterprise Zone exceeds usage outside of the Enterprise Zone". *Id.*

The taxpayer, "Marchibrod Corporation", is engaged in the lending business and makes loans to businesses located in enterprise zones. During the tax years 1996 and 1997, it made loans to two companies doing business in an enterprise zone located in parts of Amboy, Dixon and Sterling, Illinois. Tr. pp. 12, 13, 25, 26, 31. In preparing the taxpayer's returns, the taxpayer's accountant asked the taxpayer whether trucks acquired with loans from the taxpayer were qualified property. Tr. pp. 14, 15. The taxpayer indicated that the trucks were qualified property and that the interest paid on loans it received from clients owning these trucks could be deducted. Tr. pp. 14, 15, 24, 25. Accordingly, Mr. "Doe" subtracted interest the taxpayer received on loans to purchase these trucks in determining the taxpayer's Illinois income tax liability. Tr. pp. 14, 15, 24, 25.

The Department of Revenue audited the taxpayer's 1996 and 1997 income tax returns to determine the taxpayer's basis for taking deductions for interest on loans to acquire qualified property. Tr. pp. 15, 16. The auditor found that the taxpayer lacked sufficient documentation to show that trucks acquired with loans from the taxpayer were predominantly used in an enterprise zone and therefore failed to meet the criteria for classification of these vehicles as qualified property set forth in 86 Ill. Admin. Code sec. 100.2110(e)(4)(B). Tr. pp. 13, 15, 16. The taxpayer has filed a protest contesting the auditor's determination. Accordingly, the issue presented in this case is whether the auditor's determination was correct.

The taxpayer contends that it was not required to obtain logs or other source documents from borrowers showing that the trucks were predominantly used in an enterprise zone because neither the IITA nor the Department's regulations require it to maintain or produce any such documentation. Tr. pp. 4, 5, 10, 13, 14, 23, 35, 36, 37. While the section allowing the deductions the taxpayer took, 203(b)(2)(M) of the IITA, 35 **ILCS** 5/203(b)(2)(M), does not mandate the retention of any books or records, 86 Ill. Admin. Code sec. 100.9530(a)(1) provides as follows:

> 1) Every person liable for any tax imposed by the IITA shall keep books and records sufficient to substantiate all information reported on any income tax, withholding or information return required under the IITA. (emphasis added)

86 Ill. Admin. Code sec. 100.9530(a)(1)

The documentation requirements enumerated in 86 Ill. Admin. Code sec. 100.9530(a)(1) are also contained in the instructions to the IL-1120 returns filed by the taxpayer for 1996 and 1997. These instructions provide as follows:

> You must maintain books and records to substantiate any information reported on your Form IL-1120. Your books and records must be available for inspection by our authorized agents and employees.

IL-1120 Instructions (R-12/96); IL-1120 Instructions (R-12/97)

The instructions to form IL-1120 have the force and effect of Department regulations pursuant to 35 **ILCS** 5/1401 and 35 **ILCS** 5/1501(a)(19). The IITA mandates compliance with regulations and return instructions governing the maintenance and retention of records substantiating the taxpayer's deductions. 35 **ILCS** 5/501. Since the taxpayer was required to retain books and records substantiating its deduction of interest

income on loans to acquire qualified property and failed to do so, the taxpayer did not comply with Illinois law.

Moreover, the burden of proof is on the taxpayer to prove the qualification for subtraction of any items claimed as exemptions or deducted on its income tax return. Balla v. Department of Revenue, 96 Ill. App. 3d 293 (1st Dist. 1981); Telco Leasing, Inc. v. Allphin, 63 Ill. 2d 305, 310 (1976); United Airlines v. J. Thomas Johnson, Director of Revenue, 84 Ill. 2d 446, 455 (1981) ("A person claiming an exemption from taxation has the burden of proving clearly that he comes within the statutory exemption … (S)uch exemptions are strictly construed, and doubts concerning the applicability of exemptions will be resolved in favor of taxation"). The taxpayer's accountant attempted to meet this burden by showing the auditor a list of properties acquired using loans from the taxpayer that the taxpayer believed qualified for the Enterprise Zone Investment Credit and letters from borrowers stating that loans from the taxpayer were for trucks that qualified. While the type of proof required to establish the taxpayer's claims need not rise to the level expected under the Retailers' Occupation Tax Act, self serving declarations that cannot be corroborated by any documentary evidence are not sufficient to support the taxpayer's claims. Balla, *supra* at 296.

The evidence presented in this case contains no such documentary evidence to substantiate the taxpayer's deduction of interest income from loans to acquire trucks used in an enterprise zone, taken on its 1996 and 1997 tax returns. The only evidence offered to the auditor was a list of properties the taxpayer believed to be qualified properties that the taxpayer prepared and letters from officers of the taxpayer's clients indicating that the trucks constituted qualified properties. The Department's auditor was

shown no documents to substantiate these self-serving statements. Without some type of corroborating evidence, the taxpayer could not prove that the trucks for which loans were made were qualified property because it couldn't show that these trucks were used more than 50% of the time within an enterprise zone as required by 86 Ill. Admin. Code sec. 100.2110(e)(4)(B). Moreover, the taxpayer presented no evidence showing that the owners of these trucks took any enterprise zone credits on their Illinois income tax returns. In sum, the taxpayer failed to carry its burden of proving its entitlement to the deduction allowed by section 203(b)(2)(M), 35 **ILCS** 5/203(b)(2)(M). Accordingly, the Department's auditor acted properly when it denied the deduction for interest on loans to acquire trucks used in an enterprise zone because the taxpayer could not prove that the trucks acquired with loans from the taxpayer were qualified property.

The taxpayer also contends that it followed Generally Accepted Accounting Principles ("GAAP") in preparing the taxpayer's returns and that GAAP does not require it to identify source documents. Tr. pp. 4, 5, 14, 36. Generally Accepted Accounting Principles are a body of theories and principles promulgated by the American Institute of Certified Public Accountants ("AICPA") through its various rule making bodies. E. McGruder Faris, Jr., Accounting for Lawyers, at page 7 (4th ed. 1982). The record in this case contains no indication of what AICPA accounting standards or principles were relied upon by the taxpayer as a basis for concluding that source documents and other records did not have to be identified or made available for review by the auditor. Moreover, the AICPA's Statements on Standards for Tax Services No. 3, Certain Procedural Aspects of Preparing Returns states in part as follows:

> 3. If the tax law or regulations impose a condition with respect to deductibility or other tax treatment of an item, such as taxpayer

> maintenance of books and records or substantiating documentation to support the reported deduction or tax treatment, a member should make appropriate inquiries to determine to the member's satisfaction whether such condition has been met. [3]
> AICPA, Statements on Standards for Tax Services, p. 21 (2000)

As indicated above, the Department's regulations and return instructions required the taxpayer to maintain documentation to substantiate income tax deductions. The record indicates that Mr. "Doe" relied upon a list of enterprise zone properties constituting qualified properties provided by the taxpayer as a basis for taking the deductions at issue when he prepared the taxpayer's tax returns. Tr. pp. 12, 13, 14, 15, 24, 25. Mr. "Doe" made no effort to substantiate the information contained in the taxpayer's list or to determine whether such substantiating documentation even existed at the time the taxpayer's returns were being prepared. In so doing, he failed to adhere to the AICPA's standards for tax return preparation noted above.

In sum, the record does not indicate what accounting principles provided a basis for concluding that the taxpayer's returns were prepared in accordance with GAAP. Moreover, there is no evidence that Mr. "Doe" followed pertinent AICPA guidelines governing return preparation that required him to confirm the existence of documentation supporting the deductions at issue in this case. Therefore, the taxpayer has not shown that its failure to identify or produce documentation to corroborate its deductions for interest on loans to acquire qualified property conformed to GAAP requirements.

Even if the taxpayer were correct in maintaining that neither the IITA and the Department's regulations nor GAAP require it to maintain records to substantiate the deductions at issue, the taxpayer has not presented sufficient evidence to prevail in this

[3] The AICPA's Statements on Standards for Tax Services, promulgated in August, 2000, are a compilation of advisory "Statements on Responsibilities in Tax Practice" originally issued between 1964 and 1977. See

case. The Department's prima facie case was established by the introduction into evidence of copies of its Notice of Denial under the certificate of the Director. 35 **ILCS** 5/904(a); 35 **ILCS** 5/914; Balla, *supra*. To overcome the Department's prima facie case the taxpayer must present consistent and probable evidence identified with its books and records. A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826 (1st Dist. 1988); Vitale v. Department of Revenue, 118 Ill. App. 3d 210 (3d Dist. 1983); Copilevitz v. Department of Revenue, 41 Ill. 2d 154 (1968); Central Furniture Mart v. Johnson, 157 Ill. App. 3d 907 (1st Dist. 1987); Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203 (1st Dist. 1991). Testimony alone will not overcome the Department's prima facie case. Central Furniture Mart, *supra*; Mel-Park Drugs, *supra*.

The primary evidence presented at the hearing to substantiate Mr. "Doe's" testimony consists of letters from officers of the taxpayer's clients indicating that the taxpayer's loans were for trucks that were predominantly used in an enterprise zone. These letters, which were not corroborated by any witnesses, constituted out of court statements introduced to show that the taxpayer's accountant was justified in believing the unsubstantiated assertions they contained. The validity of these letters rests entirely upon the credibility of out of court assertions that could not be subject to cross examination. As such they constituted hearsay and were properly excluded from the record. People v. Carpenter, 28 Ill. 2d 116 (1963); Albertina v. Owens, 3 Ill. App. 3d 703 (5th Dist. 1971); Simon v. Plotkin, 50 Ill. App. 3d 603 (1st Dist. 1977); Hansel v. Chicago Transit Authority, 132 Ill. App. 2d 402 (1st Dist. 1971); Erickson v. Ottawa Travel Center, Inc., 69 Ill. App. 3d 108 (3rd Dist. 1979).

American Institute of Certified Public Accountants, Statements on Standards for Tax Services, p.6 (2000).

Even if the letters had not been objected to and had been admitted, the weight to be given such hearsay evidence is completely within the discretion of the hearing officer. Jackson v. Board of Review of Department of Labor, 105 Ill. 2d 501 (1985). There is nothing in the record to substantiate the assertions these letters contain that the trucks for which loans were taken were used predominantly in an enterprise zone. Consequently, these letters would have been entitled to no more weight than the unsubstantiated opinions they express. Since the letters contain unsubstantiated assertions that are not in any way connected to any books, records or other documentary evidence, they would have been entitled to little or no weight even if they had been a part of the record. *See* Manion v. Brant Oil Co., 85 Ill. App. 2d 129, 136 (4th Dist. 1967) ("It is said that 'naked opinion' unsupported by reason is entitled to little weight and that the weight and value of evidence expressed through opinions largely depends upon the foundations of fact and reason upon which such opinions stand"); Mullen v. General Motors Corp., 32 Ill. App. 3d 122 (1st Dist. 1975); St. Paul Fire & Marine Ins. Co. v. Michelin Tire Corp., 12 Ill. App. 3d 165 (1st Dist. 1973).

The taxpayer argues that its clients were not legally required to maintain logs recording trips made by the trucks they owned and therefore it could not substantiate its deductions by producing logs as the auditor requested. Tr. pp. 10, 13, 14, 32, 35, 37. The fact that the taxpayer's clients may not have been required to maintain logs does not excuse the taxpayer's failure to obtain other documentation to substantiate these deductions as required by the instructions to the tax returns the taxpayer filed. The taxpayer's clients' failure to maintain logs did not preclude the taxpayer from introducing other documentary evidence to corroborate its claim that the trucks constituted qualified

property. Since these clients were apparently trucking companies (Tr. pp. 27, 28), such evidence might have included work orders, customer receipts or invoices for cartage indicating where transported items were picked up and dropped off. The taxpayer might also have provided evidence that its clients were allowed to take Enterprise Zone Investment Credits for the trucks on their tax returns for the tax years in controversy. The taxpayer's failure to produce any evidence identified with books or records to corroborate testimony that the clients trucks purchased with loans from the taxpayer were predominantly used in an enterprise zone is fatal to the taxpayer's claims.

In sum, the record contains insufficient evidence to rebut the Department's finding that the deductions sought by the taxpayer were properly denied. Since the only evidence of record produced to support the taxpayer's position consists of unsubstantiated testimony by the taxpayer's accountant, I find that the record contains insufficient evidence to rebut the Department's prima facie case.

WHEREFORE, for the reasons stated above, it is my recommendation that the Department's denial of the taxpayer's claim for refund for the tax years 1995, 1996 and 1997 be upheld.

Ted Sherrod
Administrative Law Judge

Date: December 18, 2001